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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1941.

No. 941

THE D. W. KLEIN COMPANY, a Corporation, *Petitioner*,

v.

GUY T. HELVERING, Commissioner of Internal Revenue,
Respondent.

Petition For Writ Of Certiorari To The United States Circuit Court of Appeals For The Seventh Circuit.

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Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The undersigned, on behalf of the above named petitioner, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit entered November 28, 1941, in the above entitled proceedings, docketed therein as No. 7634.

OPINIONS.

The opinion of the United States Board of Tax Appeals is reported at pages 98 *et seq.* of the record. The opinion of the United States Circuit Court of Appeals for the Seventh Circuit is reported in 123 F. (2d) 871, and found at pages 159 *et seq.* of the record herein.

JURISDICTION.

The judgment of the United States Circuit Court of Appeals for the Seventh Circuit was entered on November 28, 1941. The jurisdiction of this Court is invoked under the provisions of Section 347(a), Title 28, U. S. C. A.

QUESTIONS PRESENTED.

The principal question presented in this case is:

1. Whether petitioner is a corporation resulting from a reorganization of the Royal Cloak Company within the meaning of Sections 112(i) and 113(a)(7) of the Revenue Act of 1932, c. 209, 47 Stat. 196, 198.

If the transactions here involved do not constitute a reorganization, then the following questions are presented:

2. Whether Section 213 (f) of the Revenue Act of 1939 (c. 247 Title II, 53 Stat. 870) prevents the addition to and increase of the basis of property acquired by petitioner in exchange for stock and the assumption of certain liabilities by the amount of cash subsequently paid in satisfaction of such liabilities.

3. Whether the bid price ($52,125) made by the Class A preferred stockholder of the bankrupt corporation for property purchased at foreclosure sale, or whether the fair market value of the said property ($84,250), is the proper basis to petitioner, the transferee corporation, for determining gain or loss upon the subsequent sale or disposition of said property.

4. Whether expenditures made by petitioner for acts done that were motivated by a purpose to protect and promote the business are proper deductions from income as ordinary and necessary expenses, notwithstanding such expenditures were made to creditors who had filed claims in bankruptcy against the predecessor corporation.

STATUTES INVOLVED.

REVENUE ACT OF 1932.

Supplement B—Computation of Net Income.

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS. (C. 209, 47 Stat. 195; 26 U.S.C.A. 111 note.)

* * * * * * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS. (C. 209, 47 Stat. 196; 26 U.S.C.A. 112 note.)

(a) General rule.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111 shall be recognized, except as hereinafter provided in this section.

(b) Exchanges solely in kind.—

* * * * * * * * * *

(4) Same—Gain of corporation.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(5) Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(c) Gain from exchanges not solely in kind.—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * * * * * *

(i) Definition of reorganization.—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS. (C. 209, 47 Stat. 198; 26 U.S.C.A. 113, note.)

(a) Basis (Unadjusted) of Property.—The basis of property shall be the cost of such property; except that—

* * * * * * * * * *

(6) Tax-free Exchanges Generally.—If the property was acquired upon an exchange described in section 112 (b) to (e), inclusive, the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. If the property so acquired consisted in part of the type of property permitted by section 112(b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. This

paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it;

(7) Transfers to Corporations Where Control of Property Remains in Same Persons.—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer;

(8) Property acquired by issuance of stock or as paid-in surplus.—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112(b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

REVENUE ACT OF 1939.

SEC. 213. ASSUMPTION OF INDEBTEDNESS. (C. 247, Title II, 53 Stat. 870, 26 U.S.C.A. Internal Revenue Acts p. 1177.)

(f) Assumption of liability not recognized under prior acts.

(1) Where upon an exchange occurring in a taxable year ending after December 31, 1923, and beginning before January 1, 1939, the taxpayer received as part of the con-

sideration property which would be permitted by subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, to be received without the recognition of gain if it were the sole consideration, and as a part of the consideration another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c) (d) or (e) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924, or subsequent revenue Acts, and shall not prevent the exchange from being within the provisions of subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts; *except* that if, in the determination of the tax liability of such taxpayer for the taxable year in which the exchange occurred, by a decision of the Board of Tax Appeals or of a court which became final before the ninetieth day after the date of enactment of the Revenue Act of 1939, or by a closing agreement, gain was recognized to such taxpayer by reason of such assumption or acquisition of property, then for the purposes of section 112 of the Revenue Act of 1938, and corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, such assumption or acquisition (in the amount of the liability considered in computing the gain) shall be considered as money received by the taxpayer upon the exchange.

(2) Paragraph (1) shall be effective with respect to the Revenue Act of 1924 and subsequent revenue Acts as of the date of enactment of each such act.

SEC. 23. DEDUCTIONS FROM GROSS INCOME. (C. 209, 47 Stat. 179, 26 U.S.C.A. 23, note.)

In computing net income there shall be allowed as deductions

(a) Expenses. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

STATEMENT.

The petitioner was organized and incorporated under the laws of the State of Illinois on February 22, 1932, to engage in the general mercantile or merchandising business, with an authorized capital stock of 4000 shares common and 4000 shares preferred stock, each of the par value of $25 per share; and petitioner issued 2085 shares of common stock to D. W. Klein and her nominees and assumed obligations of D. W. Klein in the amount of $32,125 for and in consideration of the conveyance and transfer to it on February 25, 1932, of all of the merchandise, fixtures, accounts receivable and other assets of the Royal Cloak Company and the Klein Clothing Company acquired by D. W. Klein from the Trustee in Bankruptcy of the Royal Cloak Company at Trustee's sale on January 25 and 26, 1932 (R. 99–100); all of which was done upon advice of counsel pursuant to a plan of reorganization of the Royal Cloak Company and the Klein Clothing Company for the purpose of carrying on the business of those two companies that was being conducted under the name of Klein's in the stores at Peoria, Illinois, and Burlington, Iowa (R. 32–41, 50–54, 64).

The Royal Cloak Company was a corporation organized under the laws of the State of Iowa in the year 1916, and was engaged in the business of retail sales of wearing apparel for women and children and other merchandise, having acquired the assets and business previously established by Harry Klein from 1912 to 1916, at Burlington, Davenport and Keokuk, Iowa. From 1921 to 1929 that company established additional stores in the cities of Rockford and Peoria, Illinois, Dubuque, Davenport, and Cedar Rapids, Iowa, and Bloomington, Streator, Moline and Chicago, Illinois (R. 100).

Early in 1930, the Royal Cloak Company became involved in financial difficulties because of the general business depression and during the fiscal year ended January 31, 1931, it suffered an operating loss of approximately $83,000.00 (R. 61, 101). The management undertook to effect certain economies by closing its stores in certain of the cities (R. 101). Also additional

working capital was provided. On June 15, 1931, by resolution of the stockholders, the Articles of Incorporation were amended to increase the authorized capital stock to $400,000, dividing it into three classes, Class A and Class B preferred stock, and common stock (R. 59). Mrs. D. W. Klein purchased 450 shares of Class A Preferred stock for $45,000 cash, which was all of that class of stock that was issued, and which was an emergency capital financing. The Class A preferred stock was preferred over all other classes of stock both as to dividends and as to assets of the corporation in liquidation or dissolution (R. 60–61).

The capital stock structure of the Royal Cloak Company and the stockholdings from July 31, 1931, to liquidation of the company in bankruptcy were as follows (R. 100):

	Common. Par Value $1.00	*Preferred B. Par Value $100*	*Preferred A. Par Value $100*
Authorized	50,000	250,000	100,000
Issued and outstanding	50,000	225,000	45,000
Stockholder	*Shares*	*Shares*	*Shares*
Harry Klein	20,000	1,725	None
M. A. Klein	9,000	90	None
Louis E. Klein	9,000	80	None
J. B. Klein	7,000	140	None
David S. Klein	5,000	75	None
Della W. Klein	None	None	450
	50,000	2,110	450
Treasury Stock		140	

The Klein Clothing Co. was a corporation organized under the laws of Illinois in 1922, first named the Klein-Hunt Co., and later changed to Klein Clothing Co., the object of which was to conduct a business in Peoria, Illinois, for the sale of men's clothing and furnishings. That company originally had an authorized capital stock of 300 shares, increased in 1923 to 500 shares, of the par value of $100 per share, and there were outstanding in 1931 and until its assets were distributed in complete liquidation on February 25, 1932, 350 shares of a total par value of $35,000, all of which had been issued for cash, and of which 348 shares were owned by the Royal Cloak Co. (R. 56, 101).

Notwithstanding the additional financing of the Royal Cloak Company in June, 1931, that corporation continued to lose money because of the general business depression, and it became necessary to effect some further economies and to reorganize the business; as a result of which consideration was given to closing certain of the unprofitable stores on which the company was carrying very heavy, burdensome leases. Therefore, in October, 1931, the management submitted to its counsel a plan for the creation of a new corporation that would take over the assets of the two stores in Peoria and Burlington and allow the old company to close the remaining stores in other cities, cancel the leases on buildings occupied by those stores, and liquidate the the assets. Counsel advised that no assets of the company such as the Peoria and Burlington stores could be transferred to a new company without incurring liability for payment of the obligations arising under the leases of the closed stores, so that plan was not adopted (R. 61–62, 101).

Thereupon, the management upon the recommendation of Mr. Harry Dale Morgan, a member of the law firm of Todd, Morgan, Pendarvis and Arber, of Peoria, Illinois, counsel for the corporation, gave consideration to a suggested plan whereby the assets would be transferred to a trustee for the benefit of creditors under a common law assignment (R. 101), some of which assets could be liquidated to pay off the creditors, and the problem of the unprofitable stores could be worked out over a period of time, thus effecting the payment of the creditors in full and continuing the business of the two principal stores located in Peoria and Burlington (R. 62). Counsel approved that plan, a trustee was selected, and on November 14, 1931, the company executed a common law assignment for the benefit of creditors and notice was given to all creditors (R. 101). The trustee took custody of the assets and business immediately, but on November 17, 1931, counsel and the management learned that certain persons in Chicago were buying up claims against the company for the purpose of instituting involuntary bankruptcy proceedings in Iowa; whereupon counsel advised with the officers and stockholders and recommended

a modification of the plan to meet that situation (R. 33), which was a plan for the company to file a voluntary petition in bankruptcy in the Federal Court in Illinois, arrange for the appointment of the same trustee who was acting under the common law assignment for the benefit of creditors, and have him continue the operation of the stores during bankruptcy proceedings (R. 33). The stockholders could thus work out the same plan of reorganization of the business as they had intended under the common law assignment of the assets for the benefit of creditors. Counsel advised the stockholders that by continuing the operation of the stores they would preserve the business as a going and operating concern, that they could bid in the assets at the trustee's sale and turn the operation of the stores over to a new company as a going business and thus retain the goodwill and collect a substantial part of the outstanding accounts receivable (R. 33–34, 64–65).

The summary statement of the assets and liabilities showed that the assets were approximately $120,000 in excess of the debts, but any person who purchased the assets at the trustee's sale necessarily had to continue the operation of the stores in order to realize the full value of the open accounts receivable and merchandise on hand, because from their experience in closing other stores the management knew that little or nothing would be realized on the outstanding accounts receivable if the business were entirely liquidated and the stores closed (R. 64–65).

The Receiver and Trustee closed all of the stores except those at Burlington and Peoria, and removed to those two stores all accounts receivable of the closed stores, and all merchandise and movable fixtures of the closed stores, except those at Davenport and Dubuque (R. 63, 102). The Peoria and Burlington stores thereafter continued in operation under the management of the Trustee until January 25 and 26, 1932, when he sold at public auction all the merchandise, fixtures and accounts receivable that belonged to and had been removed to those two stores; and D. W. Klein, the sole Class A preferred stockholder, acting through an agent, acquired the said assets

for the bid price of $45,625.00 (R. 102). On January 27, 1932, the Trustee sold the 348 shares of capital stock of the Klein Clothing Co. to Mrs. Klein for $6,500 (R. 102). These were substantially 70 to 75 per cent of all the assets of the Royal Cloak Company and its subsidiary (R. 62). Mrs. Klein paid the Trustee $20,000.00 in cash, executed her promissory notes for the balance of $32,125.00, took possession of the properties as of January 25, 1932, and continued the operation of the stores under the same management until they were transferred to petitioner in February, 1932, in exchange for 2,085 shares of common stock of the aggregate par value of $52,125.00, and for the assumption of Mrs. Klein's promissory notes of $32,125.00 (R. 102–103), which notes the petitioner thereafter paid.

The value of the assets when received by petitioner from D. W. Klein was not less than $84,250 free from liabilities (R. 104).

The assets of the Royal Cloak Company were recorded on the books of petitioner as of the date of January 25, 1932, at the following values:

Inventory of merchandise	$39,643.79
Accounts Receivable	83,851.16
Furniture and Fixtures	12,500.00

The Klein Clothing Co. assets were recorded on the books as of the date of February 1, 1932, at a value of $32,518.02 (R. 104).

The petitioner filed two returns of net income beginning with the operations of the business from date of acquisition of the stores by D. W. Klein—one return for the short period January 25 to January 31, 1932, and the other return for the twelve months, February 1, 1932, to January 31, 1933 (R. 103).

During the taxable year 1933, petitioner collected $73,200.59 of the said outstanding accounts receivable, arising from sales which had been returned previously as gross income of the Royal Cloak Company on the accrual basis, and which amounts were credited to surplus (R. 105). The Commissioner in computing the deficiency in tax has added that amount to petition-

er's income upon the theory that the said assets were not acquired by petitioner in connection with a nontaxable reorganization, and the Board of Tax Appeals and the Circuit Court have approved that action. The Commissioner has likewise, and for the same reason, adjusted the basis for determining gain or loss and depreciation of all other assets and for the deduction of bad debts on account of the accounts taken over from the Royal Cloak Company, and the Board of Tax Appeals and the Circuit Court have approved that action (R. 106–107). The Commissioner and the Board have held that the basis for gain or loss and depreciation of the said assets is the cost to Mrs. D. W. Klein, as transferor to petitioner, $45,625 for the Royal Cloak assets, and $6,500 for the Klein Clothing Co. assets and the Circuit Court has approved that action (R. 115–117).

During the fiscal year ended January 31, 1933, petitioner incurred and paid to creditors who had filed claims in bankruptcy against the Royal Cloak Company amounts aggregating $7,909, as set forth in the Board's Findings (R. 106–108) for services in connection with the operation of the business, for payment of a premium on a bank loan, and for service in the purchase of merchandise from manufacturers and jobbers, which amounts were claimed in the proceedings before the Board of Tax Appeals as proper deductions from gross income as ordinary and necessary expenses or as additional costs of goods sold in computing gross profit from sales. The Board and the Circuit Court have denied the deductions on the ground that they were payments made by petitioner to establish good will and lines of credit, and for the further reason that petitioner had no legal obligation to pay the claims of the bankrupt corporation.

SPECIFICATION OF ERRORS.

The United States Circuit Court of Appeals erred

1. In holding that officers and stockholders of a corporation that has been adjudged a bankrupt may not, with the full co-operation of the Trustee in Bankruptcy (whose conduct is approved by the Court) effect a reorganization of its business and property within the meaning of Sections 112(i) and 113 (a) (7) of the Revenue Act of 1932.

2. In holding that petitioner is not entitled to the same basis for the properties acquired that was recognized as the basis in the hands of the prior corporate owner, as provided by Section 113(a) (7) of the Revenue Act of 1932.

3. In holding that the basis of petitioner's property should not be increased by the amount of $32,125 cash paid to D. W. Klein, the transferor, in satisfaction of certain liabilities assumed by petitioner in 1932 upon acquisition of said property by issuance of stock.

4. In failing to hold that the basis of the property acquired by petitioner in 1932 from D. W. Klein was the fair market value ($84,250) thereof, and not the bid price ($52,125) thereof by the Class A preferred stockholder at foreclosure sale of the assets of the bankrupt company.

5. In holding that expenditures made to creditors of the predecessor bankrupt company for current services in connection with the current operation of the business, the purchase of merchandise and the payment of a premium on a bank loan, were not proper deductions from income as ordinary and necessary expenses.

REASONS FOR GRANTING THE WRIT.

1. The decision of the Circuit Court in this case is in conflict with the decisions of this Court announced on February 2, 1942, in the cases of *Helvering* v. *Alabama Asphaltic Limestone Co.*, No. 328, and *Palm Springs Holding Corporation* v. *Commissioner of Internal Revenue*, No. 503, October term, 1941, construing the provisions of Section 112(i)(1)(A) of the Revenue Act of 1928 and Section 112(i)(1)(A) of the Revenue Act of 1932, which are identical. The decision of the Circuit Court in this case is also in direct conflict with its own decisions in *Commissioner* v. *Kitselman*, 89 F. (2d) 458 and *Rex Manufacturing Co.* v. *Commissioner*, 102 F. (2d) 325, as well as the decision of the Sixth Circuit in *Commissioner* v. *Newberry Lumber and Chemical Co.*, 94 F. (2d) 447. The petitioner takes the position that Mrs. D. W. Klein, as sole owner of the Class A preferred stock, had the ownership of the equity in the property of the insolvent company, that the plan of reorganization was conceived and carried through by the medium of voluntary bankruptcy proceedings on advice of counsel to effect a continuation of her interests in the property of the insolvent company, that there was no remaining equity in the assets for participation by the other stockholders, that insolvency reorganizations are within the family of financial readjustments embraced within the terms of Section 112(i)(1)(A) of the statute, and that the separate steps of the plan whereby the assets were bid in by the Class A preferred stockholder at trustees' sale in bankruptcy were integrated parts of a single plan and constituted a "reorganization" within the meaning of the statute, as stated by this Court in *Helvering* v. *Alabama Asphaltic Limestone Co.*, *supra*.

2. The case presents for the first time a question of the construction of a statute, Sec. 213 of the Revenue Act of 1939, which has not heretofore been settled by the Supreme Court. This statute was enacted to nullify the effect of the decision of this Court in *United States* v. *Hendler*, 303 U. S. 564, 58 S.

Ct. 655, 82 L. ed. 1018, in which it was held that in a reorganization the payment of amounts to third parties in discharge by the transferee of liabilities of the transferor was a constructive receipt by the transferor and the equivalent of the receipt of cash or other property, making gain, if any, recognizable by the transferor to the extent of the liabilities assumed. Section 213 of the Revenue Act of 1939 amended Section 112 of the Internal Revenue Code and corresponding provisions of prior revenue laws beginning with the Revenue Act of 1924, to give effect to the long established policy of income tax laws of postponing in certain cases recognition of gain realized in connection with corporate reorganizations, and to permit corporations to continue bona fide business reorganizations without being subject to taxation immediately upon such reorganization by reason of the assumption by one corporation of the debts of the other in the process of reorganization. (See House Report No. 855, 76th Cong., 1st Sess., accompanying H. R. 6851, pages 18–20, and Senate Report No. 648, 76th Cong., 1st Sess., accompanying H. R. 6851, page 3.) The petitioner takes the position that Section 213(f) applies solely to transactions involving corporate reorganizations or non-taxable exchanges where there is a non-recognition of gain, and that it has no application to the basis of property acquired by a transferee corporation by the issuance of stock and the subsequent payment of cash *direct to the transferor* in satisfaction of assumed liabilities at the time of the transfer. Section 113(a)(8) of the Revenue Act of 1932 prescribes that the basis of such property to the transferee is the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. The *subsequent payment of cash direct to the transferor* for such liabilities assumed, was a gain recognized at that time to the transferor under the 1932 Act, which increased the basis of such property under Section 113(a)(8). The construction of the statute for which petitioner contends has merit, and is consistent with the decisions of this Court interpreting and construing the reorgan-

ization sections of the revenue acts, and is supported by the legislative history of Section 213 of the 1939 Act.

3. The decision below as to the application of the said statute, Section 213 of the Revenue Act of 1939, is in conflict and inconsistent with the principle applied by the Circuit Court of Appeals, Eighth Circuit, in *Helvering* v. *New President Corporation*, 122 F. (2d) 92, 96, in which it is held that the basis to the transferee corporation of assets bid in by a creditor at bankruptcy or receivership sale of an insolvent taxpayer is to be determined by the fair market value of such assets at the time of acquisition, and not the bid price of the creditor. The position taken by petitioner is that a preferred stockholder has a beneficial interest in assets of an insolvent corporation, as well as a creditor or bondholder, and that the basis for such assets acquired by a preferred stockholder at bankruptcy sale and transferred to a new corporation for stock should be the fair market value of such assets, if such value is in excess of the bid price.

4. The decision of the Circuit Court in holding that the expenditures aggregating $7,909 were not proper deductions from income as ordinary and necessary expenses, is in conflict with the decision of the Fifth Circuit in *Harris* v. *Lucas*, 48 F. (2d) 187, and is directly contrary to the principle established by this Court in *Kornhauser* v. *United States*, 276 U. S. 145, 48 S. Ct. 219, 72 L. ed. 505.

WHEREFORE, in order to have the conflict appearing herein and the question of the construction of Section 213 of the Revenue Act of 1939 definitely settled by an authoritative decision of this Court, petitioner respectfully prays that a writ of certiorari may be issued herein directed to the United States Circuit Court of Appeals for the Seventh Circuit commanding said Court to certify and send to this Court on a day certain to be therein designated a full and complete transcript of the record and proceedings of said Circuit Court of Appeals in this case

entitled *The D. W. Klein Company* v. *Commissioner of Internal Revenue*, No. 7634, to the end that said case may be reviewed and determined by this Court as provided by law, and that petitioner may have such other and further relief or remedy in the premises as to this Court may seem appropriate, and that said judgment of said Circuit Court of Appeals may be reversed by this Honorable Court.

Respectfully submitted,

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THE D. W. KLEIN COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 99–120) is unreported. The opinion of the Circuit Court of Appeals (R. 159–168) is reported in 123 F. (2d) 871.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 28, 1941 (R. 168). The petition for a writ of certiorari was filed February 11, 1942. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. The assets of a bankrupt corporation were bought at a bankruptcy sale by an individual, its sole preferred stockholder, who about a month later transferred them to the taxpayer (a new corporation), in return for its stock and the assumption by the taxpayer of the balance of the purchase price owed by the individual to the trustee in bankruptcy. The principal question presented is whether the taxpayer acquired the assets pursuant to a reorganization within the meaning of Section 112 (i) (1) of the Revenue Act of 1932, so that the basis of the assets in its hands is the same as it was in the hands of the bankrupt corporation. If there was no such statutory reorganization, the further question is presented whether the taxpayer's basis is limited to the cost of the assets to its transferor (the individual) under Sections 112 (b) (5) and 113 (a) (8) of the 1932 Act, and the retroactive provision of Section 213 (f) of the 1939 Act, or whether the taxpayer may increase its basis by adding to the transferor's cost the amount of the unpaid balance of the purchase price which it assumed.

2. Whether certain payments made by the taxpayer to creditors of the bankrupt corporation to establish credit and good will were properly dis-

allowed as deductions from income as "ordinary and necessary expenses" of the taxpayer within the meaning of Section 23 (a) of the 1932 Act.

STATUTES INVOLVED

The pertinent statutory provisions are set forth in the Appendix, *infra,* pp. 12–16.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 99–108), may be summarized as follows:

The Royal Cloak Company, an Iowa corporation, was organized in 1916 to sell women's and children's wearing apparel. It owned all of the stock, except two qualifying shares, of The Klein Clothing Company, an Illinois corporation, engaged in the sale of men's clothing. The outstanding common stock of the Royal Company all belonged to five brothers, who also owned all of the Class B preferred stock of the company. The company also had outstanding 450 shares of Class A preferred stock, which carried no voting rights; all of this stock belonged to Mrs. D. W. Klein, the wife of one of the brothers. The company operated stores in eleven cities in Iowa and Illinois. Its subsidiary, The Klein Clothing Company, operated in the Peoria store occupied by the Royal Company (R. 100–101).

In 1930 and 1931, following operating losses, the Royal Company closed three of its stores and sold a fourth. It desired to close all of its remaining

stores except the two at Burlington and Peoria. To accomplish this purpose, a plan was worked out whereby the assets of the Royal Company would be transferred to a new company; this plan, however, was abandoned upon the advice of counsel that such a transfer would not effect a cancellation of the leases for the stores which the company desired to close. Thereafter, upon the recommendation of counsel, an assignment of the company's assets for the benefit of its creditors was made to one Frankel as trustee. (R. 101.)

About two days after this assignment was made, however, it was learned that some of the creditors of the company planned to file a petition in bankruptcy against it in Iowa. Being anxious that the affairs of the company be administered in Peoria, Illinois, its principal place of business, its officers filed a voluntary petition in bankruptcy there. Frankel, the assignee for the benefit of creditors, was appointed receiver to take charge of the assets and to continue operation of the stores, and he subsequently became the trustee in bankruptcy. All of the stores, except those at Peoria and Burlington, were closed and the assets sold, with the exception of certain accounts receivable. The trustee continued to operate the stores at Peoria and Burlington until January 23, 1932. (R. 101–102.)

On January 25 and 26, 1932, the trustee offered for sale at public auction assets of the Royal Cloak Company consisting of accounts receivable and of

the merchandise, stock and fixtures of the Peoria and Burlington stores. These assets were bid in by an agent of Mrs. D. W. Klein for $45,625. On January 27, 1932, the trustee offered for sale the balance of the Royal Cloak Company's assets consisting of the stock of The Klein Clothing Company; these assets were likewise bid in by Mrs. Klein's agent, for $6,500. Both of these bids were approved by the court. On January 31, 1932, the agent assigned to Mrs. Klein all his interest in the bids. Mrs. Klein thereupon paid the trustee in bankruptcy $20,000 in cash and gave her promissory notes in the amount of $32,125 to cover the balance due on the purchase price. (R. 102–103.)

The D. W. Klein Company, taxpayer and petitioner here, was organized on February 22, 1932. On February 25, Mrs. Klein executed to the taxpayer a bill of sale of all the assets purchased from the trustee in bankruptcy, in consideration the taxpayer agreeing to issue to her its stock of the par value of $52,125 and to pay the $32,125 balance of the purchase price due from Mrs. Klein to the trustee in bankruptcy. On March 4, 1932, the taxpayer's directors accepted the bill of sale and authorized the issuance of the stock to Mrs. Klein.[1] Thereafter, taxpayer paid to Mrs. Klein the $32,125

[1] That stock, 2,085 shares of $25 par value common, issued to Mrs. Klein and her four nominees (other Kleins), is all of the outstanding stock of the taxpayer, except for some preferred stock issued in 1937 (R. 100).

due on her notes and she in turn paid it over to the trustee in bankruptcy. (R. 103.)

The assets acquired by the taxpayer from Mrs. Klein had a value at the time of the transfer of not less than $84,250. They were set up by the taxpayer on its books, as of January 25, 1932, at figures aggregating $168,512.97. (R. 104, 119.)

During the fiscal year ended January 31, 1933, the taxpayer paid certain amounts aggregating $7,909 upon various obligations which constituted claims against the bankrupt.[2] The payments (itemized in the Board's findings at R. 106–108) were in the main made to obtain credit or financing and to establish credit relations with merchandise houses. (R. 106–108.)

In arriving at the taxpayer's income tax liability for the fiscal year ended January 31, 1933, the Commissioner determined: (1) that, for the purpose of computing gain or loss on the accounts receivable and depreciation on the furniture and fixtures acquired by the taxpayer from Mrs. Klein, the taxpayer's basis was the cost of those assets to Mrs. Klein at the bankruptcy sales, $52,125; and (2) that the $7,909 paid by the taxpayer was not deductible as expenses or as additional cost of goods sold (R. 105–108). The Board sustained the Com-

[2] The distribution in the bankruptcy proceeding had amounted to approximately 30% of the proven claims (R. 108).

missioner's determination in these respects (R. 108–120) and the court below affirmed (R. 159–168).

ARGUMENT

1. The court below correctly held that the taxpayer did not acquire the assets of the bankrupt corporation in a reorganization under Section 112 (i) (1) of the Revenue Act of 1932 (Appendix, *infra,* p. 13) and that therefore the taxpayer was not entitled to use the bankrupt company's basis for those assets.

When the Royal Clothing Company went into bankruptcy, the equity of its stockholders, including that of Mrs. Klein as holder of the Class A preferred stock, was wiped out. Mrs. Klein acquired the assets of the bankrupt, not by virtue of her stock ownership, but by bidding them in for cash at the public sales held by the trustee. She then transferred the assets to the taxpayer in return for stock and the assumption by the taxpayer of the remainder of her obligation to the trustee. In this situation, it is plain, as both the Board and the court below held, "that there was no plan of reorganization carried through which included a continuation of the interests of the Royal Cloak Company or its stockholders in the petitioner, and that Mrs. Klein acted for herself alone" (R. 163). In the absence of the requisite continuity of a proprietary interest between the old and new companies, there can, of course, be no statutory reorganization.

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The decision of the court below in this case is not inconsistent with its own previous decisions in *Commissioner* v. *Kitselman,* 89 F. (2d) 458, and *Rex Manufacturing Co.* v. *Commissioner,* 102 F. (2d) 325, or in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in *Commissioner* v. *Newberry L. & C. Co.,* 94 F. (2d) 447. Similar allegations of conflict were made in the petition for a writ of certiorari in *Mascot Stove Co.* v. *Helvering,* No. 564, present Term, seeking review of a decision of the Sixth Circuit in which it was held, upon substantially the same state of facts as are here presented, that no reorganization had taken place. See 120 F. (2d) 153. This Court, however, denied certiorari.[3] The distinction between the type of situation presented in the present case and in the *Mascot Stove* case, on the one hand, and the situation presented in the *Rex, Kitselman* and *Newberry* cases, on the other, are spelled out in our brief in opposition in the *Mascot Stove* case, pp. 8–9.

There is no basis for taxpayer's assertion that the decision below is in conflict with the decisions of this Court in *Helvering* v. *Alabama Alphaltic*

[3] The present case is even weaker for the taxpayer than the *Mascot Stove* case, because here Mrs. Klein owned the assets in her own right, without any obligation to transfer them to the taxpayer, for a period of about one month between her purchase of the assets at the bankruptcy sales and her transfer of them to the taxpayer (R. 119). Cf. *Bondholders Committee* v. *Helvering,* Nos. 128 and 129, present Term, decided February 2, 1942.

Limestone Co., No. 328, present Term, and in *Palm Springs Holding Corp.* v. *Commissioner*, No. 503, present Term, both decided on February 2, 1942. In those cases this Court held that requisite continuity of interest existed for a statutory reorganization because the creditors of the bankrupt transferor corporation, who alone had effective command over the disposition of its property, were the stockholders of the new transferee company. Here such continuity of interest is lacking since, as we have pointed out, Mrs. Klein had no equity in the bankrupt corporation and became owner of its assets solely by virtue of her purchase of them for cash at the trustee's public sales.

2. The court below properly rejected the taxpayer's alternative contention that its basis for the assets should be the cost to its transferor, Mrs. Klein, increased by the amount of her obligation to the trustee in bankruptcy which the taxpayer assumed (R. 164–166).

Under Section 112 (b) (5) and 112 (c) (1) of the 1932 Act, as originally enacted, Mrs. Klein would have realized income upon her transfer of the assets to the taxpayer in the amount of her liability to the trustee in bankruptcy which the taxpayer assumed. See *United States* v. *Hendler*, 303 U. S. 564. Accordingly, under Section 113 (a) (8) of that Act, the basis of the assets in the hands of the taxpayer would have been the cost to Mrs. Klein increased by the amount of the assumed

liability. Section 213 (f) of the Revenue Act of 1939, however, retroactively changed this rule and made the transfer tax free to Mrs. Klein; consequently, under the clear terms of Section 113 (a) (8), the basis of the property in the hands of the taxpayer is simply the cost to Mrs. Klein, without any increase by virtue of its assumption of Mrs. Klein's liability to the bankruptcy trustee. Taxpayer's contention (Pet. 15–16) that the subsequent payment of the assumed obligation by the taxpayer directly to Mrs. Klein removes this case from the application of Section 213 (f) is merely an assertion unsupported by authority and without foundation in the statutory language.

3. There is also no merit in taxpayer's contention that the decision below, in its application of Section 213 (f), conflicts with *Helvering* v. *New President Corp.*, 122 F. (2d) 92 (C. C. A. 8). Section 213 (f) was not there involved, and the holding was merely that the basis for property of a bankrupt concern bought in by an agent of the mortgage creditors and then transferred to a new corporation of which the creditors were stockholders, was the fair value and not the bid price of the property. Cf. *Boldholders' Committee* v. *Helvering,* Nos. 128 and 129, present Term, decided February 2, 1942.

4. The court below correctly upheld the Commissioner's refusal to allow the payments made by the taxpayer upon the obligations of the bankrupt as

deductions as ordinary and necessary expenses of the taxpayer, or as part of the cost of the goods sold (R. 166–167). Since this question was decided by the Board and by the court below on the particular facts of this case, there is no occasion for review by this Court, and the assertion (Pet. 16) of conflicts in this respect is without merit.

CONCLUSION

The case was correctly decided below. There is no conflict of decisions and the case presents no question calling for review by this Court. The petition should therefore be denied.

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MARCH, 1942.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.*—Except as hereinafter provided in this section, the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b), and the loss shall be the excess of such basis over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(c) *Gain from Exchanges not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * *

(i) *Definition of Reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the

acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(7) *Transfers to Corporation where Control of Property Remains in same Persons.*—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 50 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased

in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section 112 (b) (5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property.

* * * * *

Revenue Act of 1939, c. 247, 53 Stat. 862:

SEC. 213. ASSUMPTION OF INDEBTEDNESS.

* * * * *

(f) *Assumption of Liability Not Recognized Under Prior Acts.*—

(1) Where upon an exchange occurring in a taxable year ending after December 31, 1923, and beginning before January 1, 1939, the taxpayer received as part of the consideration property which would be permitted by subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, to be received without the recognition of gain if it were the sole consideration, and as part of the consideration another party to the exchange assumed a liability of the taxpayer or acquired from the taxpayer property subject to a liability, such assumption or acquisition shall not be considered as "other property or money" received by the taxpayer within the meaning of subsection (c), (d), or (e) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, and shall not prevent the exchange from being within the provisions of subsection (b) (4) or (5) of section 112 of the Revenue Act of 1938, or the corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts; except that if, in the determination of the tax liability of such taxpayer for the taxable year in which the exchange occurred, by a decision of the Board of Tax Appeals or of a court which became final before the ninetieth day after the date of enactment of the Revenue Act of 1939, or by a closing agreement, gain was

recognized to such taxpayer by reason of such assumption or acquisition of property, then for the purposes of section 112 of the Revenue Act of 1938, and corresponding provisions of the Revenue Act of 1924 or subsequent revenue Acts, such assumption or acquisition (in the amount of the liability considered in computing the gain) shall be considered as money received by the taxpayer upon the exchange.

(2) Paragraph (1) shall be effective with respect to the Revenue Act of 1924 and subsequent revenue Acts as of the date of enactment of each such Act.

* * * * *

(U. S. C., Title 26, Sec. 112 note.)

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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1941.

No. 941.

THE D. W. KLEIN COMPANY, a Corporation, *Petitioner*,

v.

GUY T. HELVERING, Commissioner of Internal Revenue, *Respondent*.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

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CASES CITED.

Bondholders Committee, Marlborough Investment Co. v. Commissioner, Nos. 128 and 129, October Term 1941, decided February 2, 1942 5

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PETITIONER'S REPLY TO RESPONDENT'S BRIEF IN OPPOSITION.

The Respondent's argument that the taxpayer did not acquire the assets of the bankrupt corporation in a reorganization under Section 112 (i) (1) of the Revenue Act of 1932 is based upon the false premise that there was no plan of reorganization of the Royal Cloak Company prepared and adopted by the officers and stockholders of the corporation prior to the adjudication of *voluntary* bankruptcy.

The Board of Tax Appeals in its opinion did not deny that there was a plan of reorganization, but erroneously stated that "there was no plan of reorganization carried through which included a continuation of the interests of the Royal Cloak Company or its stockholders in the petitioner." (R. 112.)

The series of transactions evidencing the adoption of a plan of reorganization before the adjudication of voluntary bankruptcy and the acquisition of the properties by this taxpayer

pursuant to that plan, are related and set forth as undisputed facts in the Board's findings (R. 101–103), to wit:

(1) The submission by the officers of the corporation to counsel of a plan for reorganization of the Royal Cloak Company to eliminate the unprofitable stores.

(2) The recommendation by counsel that the company make a common law assignment of its assets for the benefit of creditors, which was done by instrument executed November 14, 1931. (Pet. Ex. 1; R. 80–83.)

(3) The filing by the corporation four days later, November 18, 1931, of a voluntary petition in bankruptcy at Peoria, Illinois, in order to forestall involuntary bankruptcy proceedings in Iowa.

(4) The appointment by the Court as Receiver and as Trustee in bankruptcy of the same person, Harry A. Frankel, who was trustee under the common law assignment.

(5) The continuous operation by the Receiver and Trustee of the two principal stores until the sale of the assets in January, 1932, to Mrs. D. W. Klein, the sole owner of the Class A preferred stock of the Royal Cloak Company.

(6) The organization of the taxpayer and the transfer of the assets to it in February, 1932, by Mrs. Klein in exchange for all of the stock and the assumption of her liability to the trustee.

Mrs. Klein as the sole owner of the Class A preferred stock of the Royal Cloak Company, had the preference right to the assets in liquidation, so that she had an equitable interest in the assets in liquidation, which under the plan of reorganization she effectually continued in the new company. The assets were not of sufficient value to give the other stockholders any interest.

The separate steps of the plan whereby the taxpayer acquired all of the assets of the Royal Cloak Company pursuant

to a reorganization plan consummated with the aid of the bankruptcy court, through the purchase of the assets by Mrs. Klein at trustee's sale, were integrated parts of a single plan and constitute a "reorganization" within the meaning of the statute. *Helvering* v. *Alabama Asphaltic Limestone Co.*, No. 328, October Term 1941, decided by this Court on February 2, 1942.

The Court below in its opinion recognized the existence of the foregoing transactions by the following statement (R. 164):

> "The discussion among the stockholders before the proceedings were determined upon, and their decision to initiate them as a part of what they called a plan of reorganization, acting upon advice of counsel, does not alter the character of those proceedings as actually carried out."

Also, the Court below in its opinion stated that the case presented the question, whether the facts fall within the definition of a reorganization provided by Clause B of Sec. 112 (i) (1): "a transfer *by a corporation* of all or a part of its assets *to another corporation* if immediately after the transfer the *transferor or its stockholders* or both are in control of the corporation to which the assets are transferred * * " (italics ours) (R. 162). That was the same question decided by this Court in *Helvering* v. *Alabama Asphaltic Limestone Co.*, *supra*, under a state of facts very similar to those in the present case. There the old corporation was a subsidiary of a corporation that was in receivership, the stockholders of which had financed the old corporation by taking unsecured notes for their advances. A creditor's committee was formed, a plan of reorganization was proposed providing for a new corporation to be formed and the transfer to it of all of the assets of the old corporation in exchange for stock which would be issued to creditors in satisfaction of their claims. All note holders assented, except two, and involuntary bankruptcy proceedings were instituted. The bankruptcy assets, having a value of $155,000, were offered for sale at public auction by the bankruptcy trustee and were bid in by the creditor's committee

for $15,000 cash. The bankrupt's obligations were about $838,000. Thereafter the new corporation was formed and acquired the said assets in exchange for stock which was distributed to the creditors.

Thus, in that case, if there were substituted for the creditors, a stockholder having an equitable interest in the assets, and the involuntary bankruptcy proceedings were changed to voluntary bankruptcy proceedings, the situation would be almost identical with the present case.

A similar situation also prevailed in the case of *Palm Springs Holding Corp.* v. *Commissioner of Internal Revenue*, No. 503, October Term 1941, decided February 2, 1942, which was held to be a reorganization under Sec. 112 (i) (1) A of the Revenue Act of 1932.

The respondent states (page 8) that the decision of the Court below is not inconsistent with its own previous decisions in *Commissioner* v. *Kitselman* (C. C. A. 7), 89 F. (2d) 458, and *Rex Manufacturing Co.* v. *Commissioner* (C. C. A. 7), 102 F. (2d) 325, but fails to state the reasons, except to make reference to a brief filed with this Court in *Mascot Stove Company* v. *Helvering*, No. 564, present Term, in opposition to a petition for writ of certiorari for review of a decision of the Sixth Circuit.

The case of the *Mascot Stove Company* v. *Commissioner* (C. C. A. 6), 120 F. (2d) 153, turned upon a question of fact. The *Mascot case* was an involuntary adjudication in bankruptcy, that was not planned as a step "in pursuance of a plan of reorganization." On the contrary, after the adjudication in bankruptcy, a plan was formulated by the stockholders for the acquisition of the assets by one Ziegler, as trustee or agent for the stockholders, and their transfer to a new company to continue the business. There was no plan of reorganization conceived or instituted until after the corporation became a bankrupt, and then Mr. Ziegler bought the assets from the trustee in bankruptcy and transferred them to a new corporation; and while it was true the old stockholders were permitted to become stockholders in the new company, it was not by virtue of any plan of reorganization of the old corporation.

The involuntary bankruptcy proceedings were not planned as a part of the reorganization of the old corporation as in the case of *Helvering* v. *Alabama Asphaltic Limestone Co., supra*. Thus, the assets were not properties of the bankrupt corporation at the time of the transfer to the new corporation within the meaning of the reorganization statute, but were properties of Ziegler as trustee or agent for the stockholders. The same situation prevailed in the cases of *Bondholders Committee, Marlborough Investment Co.* v. *Commissioner* and *Marlborough House, Inc.* v. *Commissioner*, Nos. 128 and 129, October Term 1941, decided February 2, 1942, and this Court made the point in distinguishing those cases from its decision in *Helvering* v. *Alabama Asphaltic Limestone Co., supra*.

The facts in the case of *Rex Manufacturing Co.* v. *Commissioner, supra*, are similar to those in the present case. The Rex Manufacturing Company, which had been engaged in business since 1898, became involved in financial difficulties during the business depression in 1930, and while its books showed assets between $600,000 and $700,000 and less than $200,000 of liabilities, it concluded its difficulties could best be solved by bankruptcy proceedings, and the formation of the successor corporation which would purchase the assets at bankruptcy sale; the plan was perfected, carried out and the bankruptcy sale held on July 10, 1930, a nominee purchased the property and thereafter conveyed it to the newly formed company, the same persons holding a beneficial interest or control in fifty per cent or more of stock of the new company equal to or in excess of that amount.

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